II. SUMMARY RECOMMENDATIONS

Arthur Andersen developed this paper via extensive discussions with and surveys of LEC Coalition members and review of FCC and state public utility commission orders, relevant legislation including the Telecommunications Act and other regulatory filings. Surveys of companies outside the telecommunications industry were also conducted with the purpose of identifying "best practices" information in the areas of accounting and recordkeeping. This research was directed at identifying areas within Part 32 that are overly detailed and/or complex as compared to the corresponding requirements and practices in other industries.

The areas with the greatest opportunity for simplification and/or elimination are as follows:

- Part 32 Account Structure and Accounting Requirements
- Property Records and Depreciation Requirements
- Affiliate Transaction Rules

Simplification opportunities in the above areas are discussed in detail in Sections IV., V. and VI. of this paper, respectively. In addition to the above areas, we assess the future role of regulatory oversight in light of the significant changes in the industry environment and the proposed changes discussed in this paper. The following summarizes each of these sections.

Part 32 Account Structure and Accounting Requirements

The Part 32 accounting structure is overly detailed and in many cases exceeds the accounting requirements of GAAP. The Part 32 account structure further does not facilitate management or external reporting and is used only for regulatory reporting in the current environment contrary to the original intent of the USOA. Charts of accounts in other industries are more closely aligned with the external reporting requirements and management information needs of the business. While management information is most often the underlying basis of such accounting systems, GAAP reporting standards must also be adhered to without exception.

In the long-term, GAAP should be relied on in the telecommunications industry with minimum regulatory intervention. The FCC can take the following steps now, however, to eliminate/streamline certain detailed requirements and provide a roadmap for the LECs to transition to full GAAP reliance:

- Reduce current level of accounting detail for **all** carriers:
  - Rely on Class B level of reporting and eliminate Class A main account detail
  - Reduce or eliminate the subsidiary record categories for various cost types

- Eliminate expense matrix categorization requirements.

- Rely on GAAP principles of materiality in regards to capitalization policy rather than using the expense limits for telecommunications plant and general support assets prescribed in Part 32.

- Rely on GAAP principles of materiality rather than the current standards prescribed in the USOA.

- Rely on GAAP standards in lieu of the current USOA advance notification requirements related to:
  - Adoption of new accounting standards.
  - Recognition of extraordinary items, prior period adjustments and contingencies.

Property Records and Depreciation Requirements

The Part 32 requirements with respect to telecommunications plant accounting and recordkeeping are significantly more detailed than what GAAP requires and should be eliminated or at a minimum significantly reduced. The level of detail at which accounts, subaccounts and detailed plant record categories are defined far exceed the recordkeeping necessary to verify the existence of plant assets and support the asset balances presented in the financial statements. To the extent that technology and/or the needs of the business change, corresponding changes in the way in which assets are managed and accounted for should also be made without regulatory delay.

The FCC can take the following steps today to streamline property accounting and depreciation requirements and provide a roadmap for the LECs to transition to full GAAP reliance:

- Reduce the recordkeeping requirements and redefine property units to allow for the accounting and tracking of telecommunications plant assets at the level of detail used by management to run its business and manage its assets.
  - Eliminate notification requirements with respect to basic property record ("BPR") plan changes
  - Eliminate detailed plant subaccounts/subsidiary record categories which exceed GAAP and asset management requirements
  - Allow for the tracking of assets on an average cost, instead of original cost, basis
  - Reduce requirements for asset tracking – continue to require asset tracking by general location (address)

- Allow carriers to set depreciation rates and methods based on economic analyses in place of the current depreciation represcription and rate setting processes.

- Rely on GAAP principles of materiality to dictate the use of expense limits rather than mandating specific limits in the USOA.

- Allow for increased flexibility (within GAAP criteria) in the determination of depreciation expense. Carriers should be able to use depreciation methods that most closely reflect the use (and decline in net realizable value) of assets. Methods such as vintage amortization life ("VAL") for non-network and immaterial network assets, that reduce the ongoing costs of asset tracking and accounting, should also be allowed.

Affiliate Transaction Rules

The affiliate transaction rules contained in Section 32.27 of the USOA are unduly complex and require carriers to incur significant costs in order to comply with such rules. In 1997, these requirements were increased, rather than streamlined, adding to the cost and complexity associated with these rules.[3] While relevant in the traditional rate of return regulation environment, the Section 32.27 rules (and related cross-subsidy concerns) are clearly less relevant under price cap regulation.

In the long-term, GAAP should be relied on in this area with minimum regulatory intervention. In the near-term, however, the following affiliate transaction requirements can be revised, simplified or eliminated:

- Eliminate the asymmetrical affiliate transaction rules with respect to the provision of services between regulated and nonregulated affiliates.

- Eliminate the application of the 50% threshold on a product-by-product and service-by-service basis, for determining the existence of a "substantial" third party market and the validity of using prevailing market prices for affiliate transactions.

- Implement a materiality-based and/or rotational requirement for performing fair market value studies in order to limit the costs of compliance.

- Expand the exemption provided in paragraph 148 of the Accounting Safeguards Order (that allows nonregulated affiliates of the LEC that *exist solely* to provide services to members of the affiliated group to price such services at cost) to:
  - Support services provided *to* affiliates that exist solely to provide services within the affiliated group
  - Specific product/service lines offered only to affiliates

[3] *Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, CC Docket No. 96-150, FCC 96-490 (rel. December 24, 1996), [hereinafter Accounting Safeguards Order].

Future Role of Regulatory Oversight

If the above changes are implemented as suggested, the role of the Federal and State regulators would most certainly change. Instead of auditing the LECs' strict compliance with detailed USOA accounting and recordkeeping requirements, regulators would shift their emphasis to more relevant business risks and issues faced by the carriers. Instead of focusing on historical regulatory compliance activities, regulators should become more proactive, facilitating the implementation of the Telecommunications Act by instituting less regulation rather than more. Compliance with the accounting and recordkeeping requirements can be more focused under a simplified USOA – instead of culling through a mass of detailed accounting data, regulators should only to the extent necessary:

- Review accounting information prepared on a GAAP basis and benchmark such data against companies operating in similar industries.

- Request accounting information on a focused, issue-driven basis.

- Review the same data that is reported to the financial community and avoid reconciliation of regulatory accounting information with externally reported financial information.

- Increase the flexibility of audit and other compliance efforts (i.e., not be bound to performing detailed compliance audits to verify the accuracy of over-detailed information just because it is reported to the Commission).

Each of the above areas for potential Part 32 simplification is explored in depth in the attached paper. The paper assesses the background of relevant USOA accounting and recordkeeping requirements and the current industry environment which is driving the need for change, compares USOA accounting and recordkeeping requirements with other industry "best practices" and provides recommendations for simplification and/or elimination of USOA requirements that can be adopted immediately transitioning to full GAAP reliance.

III. OVERVIEW AND BACKGROUND

Background on USOA Rewrite

The purpose of this section is to establish the framework for the existing rules and describe those factors necessitating the need for change.

In July 1978, the FCC issued its original Notice of Proposed Rulemaking ("NPRM") in CC Docket No. 78-196.[4] In that NPRM, the Commission "recognized the necessity of revising the USOA because the system adopted in 1935 is anachronistic in a massively more complex and competitive, technological and economic environment."[5] The overall objectives of the rewrite of the USOA were stated in the FCC's Second Notice of Proposed Rulemaking in CC Docket No. 78-196.[6] These objectives were:

- The new USOA must exist in the new competitive environment, balancing our continuing needs for regulatory information against our desire not to impose unreasonable or unnecessary reporting requirements on telephone companies.

- The new USOA should ascertain appropriate accounting categories, recognizing that it is a simpler matter to aggregate small categories than to disaggregate larger ones. The desirability of smaller categories should be carefully balanced by the concern not to impose burdens upon carriers out of proportion to the usefulness of the information provided.

- The revised USOA should not be tied to any particular cost of service methodology, as such methodologies may well change over time, with changing technology, or with relevant economic or legal considerations.

- The new accounting system should be consistent with the regulatory requirements of the new telecommunications environment.

In the Further Notice, the FCC stated its further objective that the new USOA would serve not only as a regulatory system, but also as:

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[4] *Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies*, Notice of Proposed Rulemaking, CC Docket No. 78-196, 70 FCC 2, 719 (1978), [hereinafter USOAR NPRM].

[5] *Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies*, Further Notice of Proposed Rulemaking, CC Docket No. 78-196, FCC 84-634 (rel. January 3, 1985), [hereinafter Further Notice].

[6] *Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies*, Second Supplemental Notice of Proposed Rulemaking and Order, CC Docket No. 78-196, 88 FCC 2d 83 (1981), [hereinafter Second Notice].

> "A financial accounting system which would meet the financial and primary fiduciary reporting needs of the telephone industry and would provide the body of financial data to which appropriate methodologies could be applied to develop the requisite information to satisfy both our regulatory needs and the carriers' managerial needs. In this manner efficient regulation would be served by this Commission's relying on the same database utilized by management rather than relying on data generated solely for submission to this agency."[7]

Such a design was intended to "satisfy the carriers' concerns for a financially-based accounting system to drive other external and internal reporting and decision-making models." GAAP was identified as the desired basis of accounting on which the USOA would be based, allowing for exceptions "only when the requirements of the regulatory process under the Communications Act, particularly with respect to ratemaking, mandated additional or different accounting."[8]

The revised Part 32 USOA was adopted effective January 1, 1988, coincident with the implementation and revision of the FCC's Rules and Regulations with respect to the following regulatory accounting processes:

- Part 64 Common Cost Allocation Rules - The FCC's rules under Part 64[9] set standards for allocating a regulated carrier's total costs recorded in conformity with the USOA between two aggregate categories: regulated services and nonregulated activities. The joint cost allocation rules reflect fully distributed cost principles with an emphasis on direct assignment and causal attribution of costs. LECs meeting the FCC's threshold of $100 million in annual operating revenues, as adjusted for inflation, maintain a FCC-approved cost allocation manual that describes procedures for implementing the joint cost allocation rules that also first became effective January 1, 1988.

- Jurisdictional Separations - the FCC's Part 36 rules[10] specify how the resulting regulated costs are allocated between the interstate and intrastate regulatory jurisdictions. These rules were comprehensively revised and simplified by the FCC effective January 1, 1988, replacing the former jurisdictional separations rules contained in Part 67.

- Access Charges - Regulated interstate costs identified through jurisdictional separations are next apportioned among the various rate categories for interstate services. The FCC's access charge rules under Part 69[11] were initially implemented

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[7] Further Notice, ¶ 10.
[8] Further Notice, ¶ 10-11.
[9] 47 C.F.R. § 64 et seq. (1997).
[10] 47 C.F.R. § 36 et seq. (1997).
[11] 47 C.F.R. §69 et seq. (1997).

on January 1, 1984 and revised effective January 1, 1988 consistent with the above rules changes. The access charge rules have subsequently been modified to incorporate "price cap" regulation and various FCC decisions addressing competition in the marketplace for interstate access services, most recently in the FCC's Access Reform Order.[12]

During the 1983 through 1988 time period that these proceedings took place, the telecommunications industry was undergoing significant changes in its structure and competitive environment, including:

- The divestiture of AT&T and its Bell Operating Companies ("BOCs").
- The introduction of viable competition in the interstate long-distance and enhanced services markets.
- The evolution of the access charges regime, whereby LECs would charge long-distance carriers for access to the local exchange network to originate and terminate interLATA long-distance calls.
- The removal of structural separation requirements for the provision of enhanced services by the BOCs pursuant to the Computer Inquiry III decision.[13]
- Rapid advances in technology (moving from analog to digital switching technology) and the introduction of new nonregulated services.

Clearly, the industry was in need of a simplified and up-to-date accounting system to facilitate these changes and monitor AT&T and LEC financial results under traditional rate of return regulation.

Overview of Industry Changes since Implementation of the Part 32 Rules

While the USOA has remained relatively constant, the pace of change in the industry has been unprecedented. Since the implementation of the Part 32 rules, the following events have occurred that significantly impact the industry environment and related Part 32 accounting and recordkeeping requirements:

- Adoption of price cap regulation of interstate services for AT&T effective January 1, 1990 and the LECs effective January 1, 1991 and adoption of price cap regulation of intrastate services in the majority of states in the U.S. Currently, the FCC and 31

[12] *Access Charge Reform*, CC Docket No. 96-262, First Report and Order, FCC 97-158 (rel. May 16, 1997).
[13] *Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, Report and Order, 104 FCC 2d 958 (1986), *modified on reconsideration*, 2 FCC Rcd 3035 (1987) and *Phase II Order*, 2 FCC Rcd 3072 (1987), [hereinafter referred to as Computer III].

State Commissions have adopted "pure" price cap regulation (without earnings sharing) of the dominant LECs operating in their respective jurisdictions.

- Passage of the Telecommunications Act on February 8, 1996 and issuance of resulting FCC orders implementing various Sections of the Act, including proceedings to implement local competition and interconnection as well as universal service, access charge and price cap reform.

- Emergence of competition in virtually every segment of the communications marketplace. Emergence of competitors to the incumbent LECs including competitive access providers ("CAPs"), competitive local exchange carriers ("CLECs"), enhanced service providers ("ESPs"), etc. Introduction of significant competition in the intraLATA long-distance market via 1+ dialing via presubscribed carriers other than the LEC.

- Emergence of the Internet and growth in data communications and the broadband technologies necessary to carry data at high speeds over high-capacity facilities. Rapid introduction of telephony services carried over alternative wireline networks, including the Internet, cable television and electric utility facilities.

- Emergence of wireless technologies, including personal communications services ("PCS"), and other nonregulated products and services.

All of the service providers with the exception of the incumbent LECs have the flexibility to provide services priced on a competitive basis at rates dictated by the marketplace. These service providers are not subject to the accounting and recordkeeping rules contained in Part 32 and associated monitoring and enforcement activities, but are simply required to follow GAAP in producing external reports to shareholders and investors.

The Need for Change

An analysis of the original objectives of the USOA indicates the need to revise these rules further. For example:

- Under price cap regulation, the cost of service concept on which the need for USOA detail was based is irrelevant.[14] Prices no longer bear a direct relationship to costs.

- The Part 32 accounting system is inconsistent with the regulatory requirements of the new telecommunications environment. In the pro-competitive, deregulatory environment envisioned by the Telecommunications Act, regulatory requirements

[14] While the FCC's price cap plan provides for a low-end adjustment to price cap indices in the carrier's earned rate of return falls below 10.25%, such adjustment is rarely used.

should be decreased and ultimately eliminated. Nowhere in the Act is there justification for the level of detail carriers continue to be subject to.

- Part 32 no longer serves as an external financial accounting or reporting system. Financial results reported by the LEC Coalition to the financial community are no longer based on Part 32 rules. Each of the LEC Coalition members as well as several other companies have discontinued the application of SFAS No. 71 in producing their audited financial statements that are filed with the SEC and published to the financial community.

- Management no longer utilizes USOA results to manage the business – in particular, the expenses as categorized under Part 32 do not present a clear picture of activities performed to produce a product or service. Thus, companies have designed management information systems that focus on activity-based cost information. In fact, regulatory accounting results generated in accordance with the Part 32 accounting and Part 64 cost allocation rules more often than not cause inefficient management behavior due to attempts to reconcile management information with this regulatory accounting information.

- The competitive environment has clearly changed, while the accounting and reporting requirements of the incumbent LECs have not. The Coalition LECs are not afforded the same flexibility as their competitors due to these excessive accounting and recordkeeping requirements. Competitors are not subject to these same requirements (and related costs that must be incurred to comply with the Part 32 rules). Competition has entered the local exchange market as evidenced by the following data reported by the Coalition LECs:

	Range	Average
# of CLECs operating in Coalition LECs' operating territories	53-1,099	314
# of interconnection agreements signed	222-534	344

- The use of the USOA to facilitate benchmarking of carrier performance is limited in today's environment. By obtaining detailed information via Part 32 from the LECs and not from their competitors, the Commission's ability to perform meaningful benchmarking or comparisons is limited as the FCC can only compare the USOA accounting results of LECs to other LECs. Comparisons of operational and accounting results will be most meaningful when such comparisons are made between various service providers within the industry as well as to companies outside the telecommunications industry. As such competitors and non-telecommunications companies are subject only to GAAP requirements, the only way to obtain "apples to apples" information is to utilize the same GAAP reporting standards for the LECs.

- Detailed accounting categories as prescribed by the USOA are less relevant today than they once were under traditional rate of return regulation. Such detail is not a requirement under GAAP and, again, is costly to maintain particularly given the fact that competitors to the LECs are not subject to such requirements.

Overview of "Best Practices" Comparisons with Other Industries

In conjunction with the preparation of this position paper, Arthur Andersen accumulated certain information from other capital-intensive companies of similar size operating in industries outside of the regulated telecommunications industry. Companies surveyed included those operating in other regulated industries, such as electric and gas utilities, formerly regulated industries, such as airlines and other transportation industries, and nonregulated (never regulated) industries. The purpose of accumulating this "best practices" information was to compare the LEC Coalition accounting and recordkeeping practices under Part 32 with those of other companies under GAAP and to assess the LECs' costs of compliance with specific sections of the Part 32 rules.

Our survey consisted of multi-national companies of similar size to the Coalition LECs operating in the following industries: electric and gas utilities, airlines, transportation, oil and gas, high technology, lumber/paper products and manufacturing.

In summary, the results of our survey revealed that the accounting and recordkeeping practices in companies outside of the regulated telecommunications industry are far less detailed and resource-consuming than those required under Part 32. Survey results are detailed in each individual area to which they apply.

IV. PART 32 ACCOUNT STRUCTURE AND ACCOUNTING REQUIREMENTS

Overall Summary Recommendations

The Part 32 accounting structure is overly detailed and in many cases exceeds the accounting requirements of GAAP. Further, the Part 32 account structure does not facilitate management or external reporting and is used only for regulatory reporting in the current environment contrary to the original intent of the USOA. Charts of accounts in other industries are more closely aligned with the external reporting requirements and management information needs of the business.

In the long-term, GAAP should be relied on in the telecommunications industry with minimum regulatory intervention. The FCC can, however, take the following steps now to eliminate/streamline certain detailed requirements and provide a roadmap for the LECs to transition to full GAAP reliance:

- Reduce current level of accounting detail for **all** carriers:
  - Rely on Class B level of reporting and eliminate Class A main account detail
  - Reduce or eliminate the subsidiary record categories for various cost types

- Eliminate expense matrix categorization requirements.

- Rely on GAAP principles of materiality for capitalization policy rather than using the expense limits for telecommunications plant and general support assets prescribed in Part 32.

- Rely on GAAP principles of materiality rather than the case-by-case evaluation standards prescribed in the USOA.

- Rely on GAAP standards in lieu of the current USOA advance notification requirements related to:
  - Adoption of new accounting standards.
  - Recognition of extraordinary items, prior period adjustments and contingencies.

Background on Account Structure and Accounting Requirements

Part 32 Reporting Requirements -

The Part 32 Rules became effective on January 1, 1988, replacing the prior Parts 31 and 33 as the new accounting system. Part 32 requires companies to be classified as either Class A or Class B carriers. Class A carriers are those "companies having annual revenues from regulated operations that are equal to or above the indexed revenue

threshold."[15] As defined in Section 32.9000, the "Indexed revenue threshold for a given year means $100 million, adjusted for inflation, as measured by the Department of Commerce Gross Domestic Product Chain-type Price Index (GDP-CPI), for the period from October 19, 1992 to the given year."[16]

Class A carriers are required to maintain accounting records at a significantly greater level of detail than Class B companies. At the main account level (32.xxxx), for example, Class A carriers are required to maintain information in 261 separate accounts whereas Class B carriers are limited to 109 required main accounts. Both Class A and Class B companies are required to keep Basic Property Records ("BPRs") and other subsidiary records that are "in sufficient detail to facilitate the reporting of the required specific information." The subsidiary records, in which full details are shown, shall be sufficiently referenced to permit ready information and examination by representatives of [the] Commission."[17]

Part 32 acknowledges authoritative accounting principles by stating that new accounting standards prescribed by the Financial Accounting Standards Board ("FASB") shall be incorporated into the records of the company in a manner consistent with GAAP. Any such changes in accounting shall only take effect *after* the company has submitted notification to the Commission and the Commission has approved the change, however. In such instances, concurrent with informing the Commission of its intent to adopt a change in accounting, the company "shall also file a revenue requirement study for the current year and a projection for three years into the future analyzing the effects of the accounting standards change."[18] In addition, extraordinary items, prior period adjustments and contingent liabilities are to be submitted to the Commission for review prior to being recorded in the company's records.

Finally, the FCC requires that "Companies shall follow this system of accounts in recording all financial and statistical data irrespective of an individual items materiality under GAAP."[19]

Part 32 Objectives -

As summarized in Section 32.1, the Part 32 USOA was developed as "a historical financial accounting system which reports the results of operational and financial events in a manner which enables both management and regulators to assess these results within a specified accounting period. The USOA also provides the financial community and others with financial performance results. In order for an accounting system to

[15] 47 CFR §32.11
[16] 47 CFR §32.9000
[17] 47 CFR §32.12
[18] 47 CFR §32.16
[19] 47 CFR §32.26

fulfill these purposes, it must exhibit consistency and stability in financial reporting (including the results published for regulatory purposes). Accordingly, the USOA has been designed to reflect stable, recurring financial data based to the extent regulatory considerations permit upon the consistency of the well established body of accounting theories and principles commonly referred to as generally accepted accounting principles."[20]

The USOA was structured to "reflect a functional and technological view of the telecommunications industry." The Part 32 account data, combined with underlying financial and other subsidiary records, was originally designed to "provide the information necessary to support separations, costs of service, and management reporting requirements."[21]

Two of the preceding three objectives of the USOA relate to costing and rate development processes under traditional rate of return regulation. The third objective, related to management reporting, was based on the assumption that LEC management would utilize Part 32 information to manage their business operations. Due to the changes experienced in the telecommunications industry, this management reporting objective is no longer being satisfied.

Changing Accounting Information Needs

Instead of being used as the comprehensive financial accounting and decision-making tool that the FCC envisioned upon its adoption, the USOA has evolved into a regulatory reporting system whereby accounting transactions are mapped to Part 32 accounts, subaccounts and other subsidiary record categories solely to meet regulatory reporting requirements. The degree of detail required in Part 32 in many cases exceeds the accounting requirements of GAAP, the accounting and recordkeeping practices of other industries and the needs for management reporting and imposes additional costs on subject carriers without clear benefits being derived from such detailed recordkeeping. Further, the USOA accounts, specifically in the expense area, no longer aggregate into the financial statement line items used by LECs in their reporting to the financial community and the SEC. Carriers have determined that more "generally recognizable" expense categories better facilitate financial statement users' understanding of their financial results and provide for easier comparison of such results with carriers in other segments of the communications industry and nonregulated companies in other industries.

Our research demonstrates that other industries use charts of accounts and accounting systems that more closely align with the external reporting requirements and management information needs of the business. Management information is most often

[20] 47 CFR §32.1
[21] 47 CFR §32.2

the underlying basis of such accounting systems – of course, GAAP reporting standards must also be adhered to without exception. GAAP ensures that accounting transactions are recorded and reported in an objective and consistent manner, while also ensuring the auditability of such transactions and the underlying accounting and reporting processes.

External Financial Reporting –

Beginning in 1993, each of the LEC Coalition members as well as several other LECs discontinued the application of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," for external reporting purposes. In order to apply SFAS No. 71, an enterprise that has regulated operations must meet all of the following criteria:

a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.
b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
c. In view of the demand for the regulated services or products and the level of competition, direct or indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.[22]

The majority of LECs discontinuing the application of SFAS No. 71 for external reporting purposes cited criteria b. above as their primary reason for discontinuance, noting the replacement of traditional cost-based regulation with alternative forms of regulation at the Federal and State levels, primarily price cap regulation. Several carriers also cited criteria c. above, noting the increase in competition (both current and anticipated) in virtually all market segments. Each company recorded an extraordinary charge upon discontinuance of SFAS No. 71 – these after-tax charges ranged from $2.3 to $4.7 billion. These extraordinary charges were recorded in each company's external financial statements only, as the regulatory accounting books of account were required to be maintained in accordance with the Part 32 rules. By discontinuing SFAS No. 71 regulatory accounting, the Coalition LECs brought their external financial statements in line with the accounting and external reporting practices utilized by nonregulated entities. Thus, valid comparisons can be made in the financial markets and benchmarking can be conducted involving the Coalition LECs and other LECs, their competitors and other nonregulated entities.

[22] Statement of Financial Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," ¶ 5 [hereinafter SFAS No. 71].

In addition to these one-time charges, ongoing differences in accounting between GAAP and the regulatory books of account prepared under Part 32 exist, including differences in the accounting for:

- Depreciation
- Employee benefits, including pensions and postretirement benefits other than pensions
- Income taxes
- Restructuring charges
- Regulatory assets and liabilities

This complex accounting and recordkeeping environment results in the Coalition LECs having to maintain multiple "books of account." Regulatory accounting results pursuant to the FCC's Part 32 rules are maintained for FCC reporting purposes. Differences between Federal and State accounting and ratemaking practices require state-specific records to be kept. Finally, as financial results are reported to the SEC and shareholders on a GAAP basis considering the discontinuance of SFAS No. 71, separate external reporting records must be kept. The necessary tracking and reconciliation of differences between the above accounting records adds further cost and complexity to the carriers' accounting and reporting process.

Management Accounting and Reporting -

Given the movement to incentive-based regulation, primarily in the form of price caps, and the increasingly competitive nature of the industry, companies have been aggressive in seeking to find opportunities to become more streamlined and efficient in their operations. The traditional thought of full recovery of costs through rates is less certain, and companies are looking for ways to be innovative and to reduce costs in a competitive marketplace. In light of the dynamic and competitive forces facing the industry today, a greater degree of flexibility in managing the business and reporting accounting information is critical. Companies constrained by the effects of regulation are burdened with regulatory reporting costs in an environment where their competitors have significant flexibility in setting accounting policies and reporting accounting information.

The concept of management reporting has shifted dramatically since the adoption of the Part 32 rules. Management information needs have changed, as have the organizational structures in most LECs. Reporting once deemed meaningful, centered on the reporting of results by jurisdiction along Part 32 lines, is now rarely used. Instead, information relative to customers, customer segments and specific products and services is most critical. Companies are organized into multiple business units, generally formed to serve specific types of customers and/or provide specific products, which serve customers across the LECs' operating regions instead of specific state jurisdictions. Regulatory accounting information is no longer the driver of management decision-

making and solely exists in order to be reported to the FCC and State Commissions that require reporting on that basis. Financial accounting results are analyzed and reported to all parties other than regulators based on GAAP consistent with other nonregulated entities (see SFAS No. 71 discussion above).

Other Differences -

Part 32 imposes stricter accounting requirements on companies than would be necessary under GAAP. In general, competitive companies that are not subject to regulatory constraints would use GAAP as the primary basis for recording and reporting accounting information and transactions. Other primary differences between Part 32 and GAAP include:

Recognition of Materiality. According to GAAP, materiality is to always be considered in recording and reporting results. Part 32 requires that financial information be recorded "irrespective of an individual item's materiality under GAAP."[23] One of the most noticeable disadvantages to LECs is their lack of flexibility in considering materiality in establishing expense limits on assets. LECs are required to capitalize and track *all* network assets, regardless of the associated cost. Additionally, for support assets, capitalization is required if the cost exceeds $2,000, except for personal computers which continue to have a lower expense threshold. This contradicts GAAP accounting, which says that materiality should always be considered in the decision to capitalize costs or expense them. Materiality restrictions create a cost burden to the LECs that is not present in competitive companies.

Restrictive Account Structure. Another difference between Part 32 and GAAP is the prescribed account structure that *must* be used under Part 32. Part 32 requires companies to use a predetermined and structured chart of accounts that must always be followed for regulatory accounting purposes. Other companies have significant flexibility in determining the level of account detail that is necessary in maintaining the chart of accounts pursuant to GAAP. Further, Part 32 requires that expense groups be maintained according to Plant Specific Operations, Plant Nonspecific Operations, Customer Operations and Corporate Operations categories. An "expense matrix" is required to be maintained on all expense accounts which further categorizes amounts recorded in individual Part 32 accounts within these expense categories by salaries and wages, benefits, rents, clearances, and other expenses.

Carriers must incur administrative and systems costs to track expenses by these detailed accounts and expense categories. GAAP does not require this level of detail to be maintained. Subsidiary records maintained by the LECs are considerably more detailed than that required under GAAP, exposing LECs to additional effort and costs that are not necessary to run a competitive business.

[23] 47 CFR §32.26

Segment Reporting. Lastly, a fundamental difference between GAAP accounting and Part 32 is that GAAP requires public companies to report the results of operations for *segments* of the business under SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." Current regulatory accounting under Part 32 requires *functional,* not organizational reporting, and does not facilitate the reporting of results for business units or segments as required by GAAP.

Comparison with Other Industry Accounting Requirements

As described in Section III. above, in conjunction with the preparation of this paper, Arthur Andersen accumulated certain information from other capital-intensive companies of similar size operating in industries outside of the regulated telecommunications industry. The following "best practices" information was accumulated to compare the LEC Coalition accounting and recordkeeping practices under Part 32 with those of other companies under GAAP only and to assess the LECs' costs of compliance with specific sections of the Part 32 rules:

	LECs		Non-Telcos	
	Range	Average	Range	Average
Full-Time Equivalents (FTEs) involved in General Accounting and Chart of Accounts maintenance	60-100	75	20-100	45
Cost of General Accounting/Chart of Account FTEs (in millions)	$4.5 - 7.5	$5.6	$1.5 - 7.5	$3.4

The above information shows that the LECs typically have more employees and incur greater annual costs in their "general accounting" group than the non-telcos. The LECs have a greater cost burden and decreased flexibility, as they must maintain their chart of accounts under Part 32 (as well as maintain State and GAAP records as noted above).

In surveying companies regarding the number of accounts in their current chart of accounts, we found that some non-telecommunications companies maintained an equal or greater number of accounts than the LECs. The primary reason for this is that these companies use a common chart of accounts to produce both management and financial accounting information, with management information most commonly being the driver behind the level of detail. The additional detail required to capture the activity-based cost data and necessary product/product line revenue data to manage the business results in the need for a greater number of accounts. Financial results in accordance with GAAP are usually derived via a rollup of the more detailed (management) account information.

The Coalition LECs, however, are not able to use Part 32 to capture useful management information – thus, inefficient "work-around" systems are required to produce useful

management information. Financial results are generally derived from the Part 32 accounting records, as adjusted for differences between Part 32 accounting requirements and GAAP, and management information is generated outside of the USOA structure.

Our discussions with the LECs indicated that they would benefit by having the flexibility to move to a Class B chart of accounts. Generally, the LECs believe that removing Part 32 completely would not necessarily result in fewer accounts, because many of those accounts would still be necessary for management purposes. However, the focus could be shifted towards providing meaningful management information within a simplified (Class B) chart of accounts structure.

A constant theme in each of our discussions was the "opportunity cost" that the LECs experience due to the lack of flexibility in choosing which accounts they can use. Additional flexibility in developing and maintaining their accounts would "free-up" the companies to spend their time on matters that benefit LEC customers and the advancement of competition. This is a difficult cost to measure, but all respondents agreed that additional flexibility would eventually result in material cost savings and better management information for the company.

Systems Implementation Costs -

A significant cost to many LECs that initially might not be considered is that of building Part 32 compliance into the purchase and implementation of packaged system software. LECs that have recently implemented new packaged general ledger and related feeder systems (such as accounts payable, accounts receivable, etc.) experienced significant levels of effort to ensure that Part 32 compliance was maintained in the new system. The additional costs associated with maintaining Part 32 compliance when converting to packaged systems is substantial due to the amount of customization required to enable the new systems to capture and report regulatory information according to Part 32. Typically, "mappings" must be developed to get from the native accounts of the packaged system to Part 32 accounts, creating substantial programming and system modification costs for the LECs. The on-going functionality of new systems is often severely diminished due to the level of records and data that must be added in order to comply with Part 32; systems simply cannot function as they were intended because of the large volume of data that is required under Part 32. One LEC reported that approximately 20%-25% of their *total* general ledger system implementation costs were attributable *exclusively* to customizing the system for Part 32, representing a large cost to the company. Another LEC noted that processing time is effectively *doubled* because of the level of information required by Part 32.

Recommendations

As previously discussed, regulatory constraints create substantial cost burdens to the LECs. In a competitive environment, and with the shift from traditional rate of return

regulation to price cap regulation, companies should not be forced to incur the high costs associated with complying with regulatory requirements under Part 32. Because the intent of the Telecommunications Act was to provide for a competitive marketplace within the telecommunications industry, and because the industry has moved predominantly to price cap regulation, Part 32's continued usefulness is severely limited in a competitive marketplace. Part 32 requirements hamper the flexibility and the creativity of management, and companies simply cannot effectively compete in the future if they have significant costs that their competitors do not. This scenario benefits neither the company nor the customer. As the telecommunications industry becomes more competitive, costs such as those required to comply with Part 32 that are not useful to the strategic position and management of the company should be eliminated.

Ultimately, LECs should be allowed to move completely to a GAAP basis in determining the appropriate account structure and accounting requirements to be followed. This change would eliminate the numerous "sets of books" (and related resource and systems costs) that are currently required for interstate regulatory accounting, state regulatory accounting and external reporting.

We recognize that the above recommendation of ultimately eliminating Part 32 cannot happen overnight. There are several intermediate steps that can be taken immediately by the FCC which will greatly benefit the LECs and allow some relief under current Part 32 constraints. These short-term fixes should be designed to achieve the ultimate goal of eliminating the rules in their entirety and transitioning to an accounting environment solely based on GAAP. The following recommendations are being presented to promote cost reductions and, in turn, increase the LECs competitiveness and the public interest.

Class B Account Level - Allow all LECs to report on a Class B level of accounting under Part 32. This change would be beneficial to the LECs, as it would reduce the amount of detail required for regulatory reporting. Consistency would continue to be maintained within the industry and Class B would significantly streamline the account structure. Class B would continue to satisfy the reporting requirements of Parts 36 and 64 as evidenced by the fact that Tier 2 companies have used the Class B account structure historically.

In addition to reductions in the total number of accounts required to be maintained under a Class B structure, LECs would be relieved of much of the burdensome FCC reporting requirements (primarily the ARMIS financial reports). Management would likely keep a significant number of accounts for internal analysis; however a higher degree of flexibility in the maintenance of those accounts would be afforded. Adoption of a Class B account standard would not represent a significant departure from the current regulatory rules. Both the FCC and State Commissions are familiar with Class B accounts and hold the vast majority of LECs to that standard of reporting currently.

If a Class B account structure were adopted for all LECs, subsequent regulatory processes including Part 64 common cost allocations, Part 36 jurisdictional separations and rate development under the Part 69 access charge rules would be largely unaffected. The Part 36 and Part 69 rules are already based on a Class B level of account detail, so no changes to such rules would be required. The Part 64 cost allocation process, while based on a Class A level of account detail today, could be converted to a Class B level without a significant impact on the regulated/nonregulated cost allocation results. The Part 64 rules "reflect a fully distributed costing methodology, with emphasis on direct assignment and cost causation."[24] Costs recorded in Part 32 accounts (today under Class A or in the future under Class B) are further categorized into homogenous cost pools and then directly assigned or attributed/allocated to regulated or nonregulated activities. The existing cost pool apportionment process would serve to continue to properly categorize costs into like categories and facilitate an accurate, efficient and effective allocation of costs between regulated and nonregulated activities.

Eliminate Expense Matrix - The requirement to maintain an expense matrix for each Part 32 expense account for salaries and wages, benefits, rents, other expenses, and clearances should be eliminated. Maintaining and tracking these expenses is an administrative cost burden to the LECs. Typically, competitive companies are not restricted as to how they track expense elements and most have the flexibility to determine their own desired level of expense tracking. Under price cap regulation, tracking these expense elements provides little or no benefit to the company or to consumers.

Eliminate Subaccount Detail Requirements - Maintaining subaccount detail provides no benefit to the LECs, and in some instances puts the company at a strategic disadvantage by requiring the company to disclose its mix of technology to competitors. Competitors do not have to disclose this type of information. Additionally, the large number of accounts and detail subsidiary records creates considerable costs that could be avoided. The Coalition LECs indicate that account reconciliations and trending would be much less complicated and time-consuming if the subaccount level of detail were removed. For example, "a switch is a switch," and separate identification by Step-by-Step, Crossbar, Other Electromechanical, Analog and Digital switching is not necessary. In the long-run, fewer accounts would lead to lower systems processing times and costs and would allow the LECs to be more flexible and responsive to the needs of managing the business in a manner that is driven by a competitive marketplace.

Increased Flexibility in Adopting "New GAAP" and Eliminate Notification Requirements - LECs should not be required to notify the FCC prior to adopting new accounting standards and furthermore should not be required to file complex revenue requirement studies that have little relevance under price cap regulation. Revenue

[24] *Separation of Costs of Regulated Telephone Services from Costs of Nonregulated Activities*, CC Docket No. 86-111, 2 FCC Rcd 1298 (1987), ¶ 2, [hereinafter Joint Cost Order.]

requirement studies are costly and burdensome to the company. Competitive companies are not required to receive approval to adopt new authoritative accounting standards nor is approval (other than standard SEC approval) required prior to making accounting changes involving the application of existing standards. Allowing carriers to adopt new accounting standards would also reduce the differences between, and additional cost of maintaining, two sets of books (GAAP and USOA).

Other notification requirements included in Section 32.25[25] should also be eliminated. Commission review of extraordinary items, prior period adjustments (FCC approval required for "material" adjustments) and contingent liabilities prior to such accounting entries being recorded in the books of account is excessive and creates unnecessary delay in the accounting process. GAAP contains sufficient guidance in each of these areas that can be relied upon in lieu of Commission intervention, as follows:

- Extraordinary items – Accounting Principles Board ("APB") Opinion No. 30, "Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions."
- Prior period adjustments – SFAS No. 16, "Prior Period Adjustments."
- Contingent liabilities – SFAS No. 5, "Accounting for Contingencies."

[25] 47 CFR §32.25

V. PROPERTY RECORDS AND DEPRECIATION

Overall Summary Recommendations

The Part 32 requirements with respect to telecommunications plant accounting and recordkeeping are significantly more detailed than what GAAP requires and should be eliminated or at a minimum significantly reduced. The level of detail at which accounts, subaccounts and detailed plant record categories are defined far exceed the recordkeeping necessary to verify the existence of plant assets and support the asset balances presented in the financial statements. To the extent that technology and/or the needs of the business change, corresponding changes in the way in which assets are managed and accounted for should also be made without regulatory delay.

The FCC can take the following steps now to relieve the LECs from certain detailed property accounting and depreciation requirements and provide a roadmap for the LECs to transition to full GAAP reliance with minimal regulatory intervention:

- Reduce the recordkeeping requirements and redefine property units to allow for the accounting and tracking of telecommunications plant assets at the level of detail used by management to run its business and manage its assets.
  - Eliminate notification requirements with respect to basic property record ("BPR") plan changes
  - Eliminate detailed plant subaccounts/subsidiary record categories which exceed GAAP and asset management requirements
  - Allow for the tracking of assets on an average cost, instead of original cost, basis
  - Reduce requirements for asset tracking - continue to require asset tracking by general location (address)

- Allow carriers to set depreciation rates and methods based on economic analyses in place of the current depreciation represcription and rate setting processes.

- Rely on GAAP principles of materiality to dictate the use of expense limits rather than mandating specific limits in the USOA.

- Allow for increased flexibility (within GAAP constraints) in the determination of depreciation expense. Carriers should be able to use depreciation methods that most closely reflect the use (and decline in net realizable value) of assets. Methods such as VAL for non-network and immaterial network assets, that reduce the ongoing costs of asset tracking and accounting, should also be allowed.

Background on Section 32.2000

The USOA is unique in that it prescribes very detailed requirements for the recording, tracking, depreciation and retirement of each LEC's fixed assets. The telecommunications plant accounting, basic property records and depreciation accounting requirements contained in Section 32.2000 of the USOA far exceed the property and depreciation accounting and recordkeeping "best practices" in other industries and the information required by management to effectively manage its assets.

Pursuant to GAAP, companies are required to maintain an internal control structure that provides for the verification of asset balances in support of amounts presented in the financial statements. GAAP requires that assets be accounted for at their original cost, tracked (on an original or average cost basis) as to location, depreciated over their estimated economic useful lives, and retired from the books of account on a timely basis. The realizability of plant assets (in the form of future revenues expected to be generated from such assets) must also be assessed and an impairment loss recorded if the future cash flows to be generated from the use of such assets are less than their current net book value.

Consolidating continuing property record ("CPR") units and the USOA telecommunications plant accounts would significantly reduce the costs incurred in tracking plant assets. Further, increased flexibility should be granted to allow management to simplify and revise its property units consistent with how such assets are managed. The requirement that LECs file all proposed changes to its BPR plan with the FCC limits carrier flexibility.

Section 32.2000 of Part 32 provides instructions specifically pertaining to telecommunications plant accounts, including depreciation.[26] Section 32.2000 states that the plant accounts are designed to reflect the LECs' investment in tangible and intangible assets with a useful (service) life exceeding one year. The rules dictate the value (i.e., original cost) at which the LECs should record the investment and provide detailed guidance as to what types of costs should be capitalized for plant constructed by the LECs, (i.e., all direct and indirect costs), including labor, engineering, materials and supplies, transportation, contract, taxes and interest. Further, the rules provide specific direction with respect to:

- The purpose of the telecommunications plant accounts and detailed descriptions of each main account, subaccount and subsidiary record category.

- Telecommunications plant asset retirement accounting procedures, including guidance as to the cost amount to be used when retiring specific assets and the defined retirement units.

[26] 47 CFR §32.2000

- Basic Property Record ("BPR") requirements - the type of asset information that should be tracked, including identity, vintage, location and original cost of each property unit.

- Continuing Property Records ("CPR") - detailed records that must be maintained, by main Part 32 account and subaccount and individual accounting area (the geographic area in which the plant is placed), for each property record unit in support of the BPR.

- Depreciation and amortization accounting procedures, including rules with respect to the calculation of depreciation rates and charges.

- Guidance on accounting for software.

Basic Property Record Plans

As discussed above, Section 32.2000 requires LECs to file a BPR plan with the FCC. The BPRs are designed to preserve such detailed information as:

- The identity, vintage, location and original cost each property unit.

- Original and ongoing transactional data (i.e., plant account activity) for the property units.

- Other information which might be required to support the financial information needs of the LECs.

The BPRs must be subject to internal controls, auditable and sum to equal the total plant investment of the LECs and shall consist of, and be supported by, the CPRs. Each LEC must establish and maintain BPRs for each class of property recorded in the plant accounts which comprise Part 32 Accounts 2001, "Telecommunications Plant in Service," 2002, "Property Held for Future Telecommunications Use," and 2006, "Nonoperating Plant." The BPR plan must include a list of accounting areas, accompanied by the boundaries of each area, and a list of the property record units to be used for each plant account. Any major proposed changes to the BPR plan must be filed with the FCC 30 days prior to the effective date of such changes.

The CPRs must be compiled on the basis of original cost and must be maintained to meet the following objectives:

- Provide for the verification of property record units by physical examination.

- Provide for accurate accounting for retirements.

- Provide data for use in connection with depreciation studies.

The CPRs must be established and maintained in subaccounts for each accounting area. Within each accounting area, each property record unit must be listed separately with its original cost, description, location, date of placement and details of construction. This detail is required so as to provide for information necessary to remove original cost upon the retirement of a property unit. All changes to the CPR (other than changes due to telecommunications plant addition and retirement activity) must be submitted to the FCC. A complete description of each property record unit must include the identification of the construction work order, year of installation, specific location within each accounting area to ensure proof of physical existence and the property record unit's identification number. The CPR must disclose the age of existing property, and supplemental records to the CPR must disclose the service life of property retired. In addition, the source of all entries into the CPR must be referenced which supports the quantities and costs recorded in the CPR.

Expense Limits

The FCC allows the LECs to expense individual general support assets that cost less than $2,000. As stated by the FCC in its 1997 Expense Limits Order[27], "The purpose of the expense limit is to reduce the cost of maintaining property records for the acquisition, depreciation, and retirement of a multitude of low-cost, high-volume assets. Increases in the expense limit are made periodically to recognize the effects of inflation, technological changes, and changes in the telecommunications regulatory environment."[28] Previously, the expense limit in Part 32 was raised from $200 to $500 for these assets in 1989. In its Order, the FCC noted the following arguments in support of the $2,000 limit[29]:

- The increased savings from reduced recordkeeping under the higher limit would improve their [LECs] ability to compete effectively in an increasingly competitive environment.

- The $2,000 limit is more comparable to the expense limits of other regulated and nonregulated businesses, and would allow carriers to react more quickly to technological changes in the future.

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[27] *Revision to Amend Part 32, Uniform System of Accounts for Class A and Class B Telephone Companies to Raise the Expense Limit for Certain Items of Equipment from $500 to $750*, Report and Order, CC Docket No. 95-60, FCC 97-188 (rel. May 30, 1997), [hereinafter Expense Limits Order].
[28] Expense Limits Order, ¶ 4.
[29] Expense Limits Order, ¶ 9.